

Before The  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION  
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In the Matter of

Implementation of Sections of the  
Cable Television Consumer Protection  
and Competition Act of 1992

Rate Regulation

)  
)  
) MM Docket Nos.  
) 92-266 and 93-215  
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COMMENTS OF  
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### Summary

Affiliated Regional Communications, Ltd.

("ARC") principally provides regional sports programming to cable operators and other multichannel video programming distributors. The Commission's proposal to eliminate the 7.5 percent mark-up on cost increases for programming services carried before May 15, 1994 will have a disproportionately adverse effect on regional services, particularly regional sports networks. Elimination of the mark-up necessarily would result in declining operating margins for cable operators, thereby increasing the already significant pressures to move higher-cost regional services from regulated tiers and the disincentives to add such services to those tiers.

ARC respectfully submits that the Commission's proposal is unsupported by the record and contrary to its reasoning in adopting the going forward rules. The 7.5 percent mark-up on programming cost increases was not intended solely to encourage the addition of new services. The Commission made clear that the mark-up applied "to any additional programming cost for a tier, measured on a per subscriber basis occurring after May 15, 1994." In explaining the calculation of the mark-up, the Commission left no doubt that it applied to both the cost of additional programming services and increases in the cost of existing services. The Commission recognized that the 7.5 percent mark-up was a "cautious choice" intended to maintain a reasonable rate of return

on programming services as the cost of those services continued to increase in the future.

The Commission expressly has stated that the per-channel adjustment and License Fee Reserve under the new going forward rules are intended only to "provide full and fair compensation to operators adding channels to CPSTs." Specifically, the per channel adjustment does nothing more than "compensate the operator for its costs of adding the channel plus a reasonable profit." In short, "the per channel adjustment is imposed to approximate rate adjustments an operator facing effective competition would receive for adding a channel."

The "operator's adjustment" and "License Fee Reserve" for newly-added services do not preserve a cable operator's margin -- which the Commission already has reduced to "competitive" levels -- on existing programming services as their cost increases. Indeed, the Commission expressly stated that the new going forward methodology did not take into account or compensate for increases in the costs of programming already carried on the system. Because its rules compensate cable operators for only the cost of adding a service, the Commission also should reconsider in this proceeding its decision to eliminate any margin on future increases in the cost of newly-added services.

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**COMMENTS OF  
AFFILIATED REGIONAL COMMUNICATIONS, LTD.**

Affiliated Regional Communications, Ltd. ("ARC") submits these comments in response to the Commission's Sixth Order on Reconsideration, Fifth Report and Order and Seventh Notice of Proposed Rulemaking, FCC 94-286 (rel. Nov. 18, 1994) ("Seventh Notice") in these proceedings.<sup>1</sup> The Commission's proposal to eliminate the 7.5 percent mark-up on cost increases for programming services carried before May 15, 1994 is unsupported by the record and contrary to its reasoning in adopting the new "going forward" rules. Elimination of the mark-up necessarily would result in declining operating margins for cable operators, thereby increasing the already significant pressures to move higher-cost regional services from

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<sup>1</sup> As ARC has explained in previous comments in MM Docket No. 92-266, ARC, which presently does business as Liberty Sports, and/or its predecessors have provided regional sports programming to cable operators and other multichannel video programming distributors since 1983. ARC also has ownership interests in several national sports programming services.

regulated tiers and the disincentives to add such services to those tiers.

### Introduction

Convinced that its "current rules...do not a create a sufficient incentive for most [cable] operators to provide subscribers with additional channels," the Commission amended its going forward rules to provide further "incentives for adding channels to a cable operator's offerings" on regulated cable programming service tiers ("CPSTs").<sup>2</sup> Seventh Notice at ¶3. For services added to CPSTs on or after May 15, 1994, cable operators may increase rates using the new methodology after January 1, 1995. Id. at ¶8. The Commission concluded that the new going forward methodology "will provide an adequate incentive to operators to add new services to CPSTs, while protecting subscriber interests by keeping overall regulated rates reasonable." Id. at ¶10.

Although compensating cable operators for the cost of adding programming services to CPSTs, the Commission's "alternative methodology" imposes a potentially severe penalty on future cable operating margins. By electing to proceed under the new rule, a cable operator forfeits the 7.5 percent

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<sup>2</sup> The new going forward rules establish "an alternative channel adjustment methodology" which includes "a flat fee mark-up" of 20 cents per channel for each new channel, subject to an aggregate "Operator's Cap" of \$1.20 and a "License Fee Reserve" of 30 cents through December 31, 1996. Seventh Notice at ¶¶8-9, 11, 64. In 1997, an additional per-channel adjustment of 20 cents is available and license fees are no longer subject to the cap or reserve.

mark-up on future increases in the cost of any new programming service added on or after May 15, 1994. Seventh Notice at ¶9. In addition, the Commission tentatively has concluded that the 7.5 percent mark-up on future increases in the cost of programming services carried before May 15, 1994 "is unnecessary" for cable operators proceeding under the new methodology "given the total incentive structure provided in our revised going forward rules." Id. at ¶133. The Commission also has solicited comment "on whether operators electing to use the current going forward rules should be permitted to pass-through the 7.5% mark-up on programming cost increases after the initial mark-up on the programming cost of new channels." Id. at ¶134.

In short, after the one-time rate increase for a newly added programming service to a CPST, which increase the Commission carefully limited to compensation for the cost of adding that service, the Commission proposes to prohibit cable operators from earning any return on all future cost increases not only for that channel, but also for all existing programming services on rate-regulated service tiers. ARC respectfully submits that the Commission's proposal is contrary to the detailed empirical bases for its going forward rules and would have a disproportionately adverse effect on the carriage of higher-cost services such as ARC's regional sports networks.

I. The 7.5 Percent Mark-Up On Programming Cost Increases Was Not Intended Solely To Encourage The Addition Of New Services.

From the outset of these proceedings, the Commission has acknowledged that programming costs historically "have increased at a rate far exceeding the rate of inflation" and has afforded "external" treatment for those costs, permitting cable operators to "pass through" programming cost increases to consumers to the extent that they exceeded the rate of inflation. See Report and Order and Further Notice of Proposed Rulemaking, MM Docket No. 92-266, 8 FCC Rcd. 5631 (1993), at ¶251. The Commission subsequently recognized that, after cable operators reduced regulated rates by the 17 percent "competitive differential" identified by the Commission, they would experience declining profit margins if future programming cost increases were merely passed through without a "mark-up" by the cable operator. Consequently, the Commission took additional steps intended to ensure that, on a going forward basis, regulated rates would continue to: (a) remain at reasonable and competitive levels for consumers; (b) provide reasonable rates of return for cable operators; and (c) provide cable operators with adequate incentives to add new programming services.<sup>3</sup>

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<sup>3</sup> See Second Order on Reconsideration, Fourth Report and Order, and Fifth Notice of Proposed Rulemaking, MM Docket No. 92-266, 9 FCC Rcd. 4119 (1994) ("Second Order on Reconsideration"), at ¶231 ("the methodology...should achieve the objectives of protecting consumers from unreasonable rates while assuring the continued growth of the cable industry and the additional services that it can provide to subscribers").



The Commission expressly provided for a 7.5 percent mark-up on programming cost increases -- regardless of whether those increases resulted from the addition of new programming services to regulated tiers or from higher license fees for existing services on those tiers. Although the Commission now indicates that it "did not directly adopt the 7.5% mark-up on increases in programming costs of channels offered before May 15, 1994" (Seventh Notice at ¶134 n.48\*), it broadly stated that the mark-up would apply to additional programming costs on or after that date. For example, the Commission explained that the mark-up applied "to any additional programming cost for a tier, measured on a per subscriber basis occurring after May 15, 1994." Second Order on Reconsideration at ¶246 (emphasis added).

The Commission left no doubt that the mark-up applied to both the cost of new programming services and increases in the cost of existing programming services:

If a cable operator is merely restructuring tiers and there is no change in the total number of regulated channels, then the operator would find its total number of regulated channels in the table, note the corresponding per channel adjustment factor, and calculate adjustments in network costs per tier as explained earlier in this paragraph. After the residual component of the tier charge is adjusted in this fashion, all external costs, including programming expenses, will be combined with the adjusted residual to determine the final tier charge. As stated, any increased level of programming expense will be entitled to a 7.5 percent mark-up.

Second Order on Reconsideration at ¶248 (emphasis added).

Thus, the purpose of the 7.5 percent mark-up was not limited solely to providing an incentive for cable operators to add new services. It also was intended to maintain a reasonable rate of return on existing programming services as the cost of those services increased in the future:

[I]n our Cost Proceeding, we have identified 11.25% as a reasonable rate of return for an operator's investment in provision of regulated cable services. We believe that the mark-up on programming expense should be less than the rate of return on longer term investment in assets such as tangible plant in service. On the other hand, in order to help assure the continued growth of programming services, we believe that the mark-up we established at the outset of our going-forward methodology should not be established at a minimal level. We thus choose 7.5% as a cautious choice for an initial permitted mark-up on programming expense.

Second Order on Reconsideration at ¶245 n.345 (emphasis added).<sup>4</sup>

The Commission's rationale for choosing a lower rate of return on programming assets -- because of their shorter useful life -- compels the conclusion that the same rate of

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<sup>4</sup> Cable operators and programmers requested the Commission to increase the 7.5 percent mark-up because such lower mark-up would erode a cable operator's margin on existing services over time. See, e.g., Comments of Time Warner Cable in Response to the Fifth Notice of Proposed Rulemaking in MM Docket No. 92-266, filed on June 29, 1994, at 6-7 (pass-through of increases in the cost of existing programming services should include "a mark-up of at least 15 percent on these increases" to preserve cable operator's margin on those services); Comments of Discovery Communications, Inc. in MM Docket No. 92-266, filed on June 29, 1994, at 8-9 ("Discovery also urges the FCC to increase the mark-up on incremental programming expenses for currently carried cable networks" because programmers will be unable to "acquire and produce new and resource-intensive original material if operators are strongly disinclined to support such investments in quality" in the future).

return must be provided on increases in the cost of future purchases of those assets.<sup>5</sup> With each additional purchase of programming from an existing programming service at a higher cost, a cable operator is effectively purchasing an additional asset essential for providing cable service. Even with the 7.5 percent mark-up, that operator's effective rate of return continues to be reduced over time. Eliminating any mark-up would unfairly and unreasonably accelerate such reduction.

II. The Optional Per-Channel Adjustment Under The New Going Forward Rules Was Neither Calculated Nor Intended To Provide Cable Operators With A Margin On Future Programming Cost Increases.

Although the new going forward rules were intended to provide an "alternative...methodology" for adjusting regulated CPST rates for adding new programming services after May 15, 1994, the Commission's Seventh Notice and the accompanying Technical Appendix confirm that the methodology makes no provision for increases in the cost of new programming services, much less programming services carried prior to May 15, 1994. Rather, the Commission expressly has stated that the per-channel adjustment and License Fee Reserve under the new rules are intended only to "provide full and fair compensation to operators adding channels to CPSTs." Seventh Notice at ¶83.

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<sup>5</sup> The Commission consistently and unequivocally has characterized the acquisition of programming as the purchase of an asset. See, e.g., Report and Order and Further Notice of Proposed Rulemaking, MM Docket No. 93-215, 9 FCC Rcd. 4527 (1994), at ¶267.

Specifically, the 20 cents per channel adjustment does nothing more than "compensate the operator for its costs of adding the channel plus a reasonable profit." Seventh Notice at ¶73. Thus, the Commission staff explains that:

Our basic methodology in examining the per channel adjustment factor was to estimate the current cost of adding a new channel under competitive conditions. It was not possible to observe these costs from current data, since comprehensive industry cost data are not available. Therefore, we estimated the cost of a channel addition from historical data. We first recognized that the historical data that were available to us were in the form of rates or prices charged, rather than in the form of costs. To go from rates to a system's costs of adding a new channel, we adjusted the data for inflation, market power, and programming costs.

Id., Technical Appendix at 4 (emphasis added, note omitted). In short, "the per channel adjustment is imposed to approximate rate adjustments an operator facing effective competition would receive for adding a channel." Id. at ¶79. Likewise, the License Fee Reserve was intended only "to replicate the incentives operators would have to add channels in a competitive environment." Id. at ¶82.

Nowhere did the Commission find that the 20 cents per channel adjustment and License Fee Reserve ensured that cable operators would receive "full and fair compensation" for new programming services added to a CPST and a fair and reasonable return on future investments in those services and existing services. Indeed, the Commission expressly stated that the new going forward methodology did not take into

account or compensate for increases in the costs of programming already carried on the system:

The 30 cents License Fee Reserve would allow 6 channels to be added at an average license fee of 5 cents per channel. The 5-cents average, per channel license fee falls within the historical range of 4-12 cents which we observed. Within that range, we determined that a choice toward the lower end of the range was appropriate because the 12 cent upper figure included price increases for programming already on operators' systems as well as for new programming.

Seventh Notice at ¶81 (emphasis added).<sup>6</sup>

After having excluded "price increases for programming already on operators' systems" and making no provision for future price increases, the Commission cannot now claim that the 7.5 percent margin on programming cost increases is "no longer...necessary given the total incentive structure provided in our revised going forward rules."

Seventh Notice at ¶133. The "operator's adjustment" and "License Fee Reserve" for newly-added services do nothing to preserve a cable operator's margin -- which the Commission already has reduced to "competitive" levels -- on existing programming services as their cost increases. Indeed, because

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<sup>6</sup> Consistent with the Commission's reasoning and conclusion, the Commission staff explained that:

By focusing only on the license fees associated with newly introduced services, we excluded license fee increases associated with channels already on some cable systems. In addition, we could better account for programmers' practice of discounting license fees in the year that a new service was introduced.

Seventh Notice, Technical Appendix at 21.

its rules compensate cable operators for only the cost of adding a service, the Commission also should reconsider in this proceeding its decision to eliminate any margin on future increases in the cost of newly-added services.

III. Eliminating The 7.5 Percent Margin On  
Future Programming Cost Increases Will  
Have A Disproportionately Adverse Effect  
On Regional Services.

Regional programming services, particularly the sports networks programmed by ARC, will be harmed disproportionately by elimination of the 7.5 percent margin on cost increases for existing and new programming services. The Commission has recognized that regional networks tend to be more expensive than other programming services. See, e.g., Second Report and Order, MM Docket 92-264, 8 FCC Rcd. 8565 (1993), at ¶78 (local and regional programming services have higher license fees than other services because they are "costly to produce and appeal only to a limited population of subscribers"). The nature of the programming on regional sports services also contributes to their higher cost. Professional and collegiate sports leagues and teams demand substantial rights fees; live coverage of sports events requires significant personnel and equipment expense; and the featured programming, generally consisting of live sports events, has little residual value after game day. See, e.g., ARC Petition for Reconsideration in MM Docket No. 92-266, filed on June 21, 1993, at 6. The license fees of regional

sports networks to cable operators may increase when significant new costs are incurred in adding the contests of new collegiate conferences or professional sports teams (which, for example, may relocate from one city to another) or in extending existing rights agreements.

As a result, regional sports networks will be particularly hard hit by elimination of the mark-up on cost increases for existing programming services. Although cable operators are permitted to pass through these rate increases, absent a percentage mark-up on such increases, a cable operator's margin on the regulated tier containing a regional service will decrease. If cable operators are precluded by the Commission's proposal from maintaining their existing margins as programming costs continue to increase, they will be increasingly likely to discontinue carriage of those networks or to attempt to shift them from regulated tiers to a-la-carte offerings, thereby decreasing their distribution and increasing their cost to subscribers. At the very least, the Commission's proposal will substantially increase cable operator resistance to cost increases for regional programming services which inhibits the ability of those services to recover their investments in new and better programming -- investments advancing the objectives of localism and diversity recognized

by the Cable Television Consumer Protection and Competition Act of 1992.<sup>7</sup>

### Conclusion

In initially adopting the 7.5 percent mark-up on programming cost increases, the Commission admittedly took a "cautious" approach. The mark-up does not represent any financial windfall to cable operators, but at best merely allows them to maintain existing margins which the Commission already has reduced to "competitive" levels. Because the per-channel adjustment under the new going forward rules only compensates cable operators for the cost of adding new programming services, it provides no substitute for the 7.5 percent mark-up on cost increases for those new services, much less all other existing programming services. Elimination of that mark-up would have a particularly deleterious impact on higher-cost regional services. For the foregoing reasons, ARC respectfully requests that the Commission abandon its current proposal to eliminate completely the 7.5 percent mark-up and

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<sup>7</sup> Regional sports networks may add significant new collegiate or professional packages by adding a surcharge to their existing licensing fees to cable operators and other multichannel video programming distributors. If the Commission's proposal were adopted, cable operators would be increasingly unwilling to pay such surcharges, thereby making the additional programming unavailable to viewers or available at a substantially higher cost through pay-per-view programs.



reconsider its decision to eliminate the 7.5 percent mark-up  
on cost increases in newly-added programming services.

January 13, 1995

Respectfully submitted,

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